87-1140

No. _____

Supreme Court, U.S.
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IN THE SUPREME COURT OF THE UNITED STATES

October Term of 1987

JOYCE PURCELL,

Petitioner-Appellant

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

The questions presented for review are as follows:

1. Whether income tax deductions for worthless stock and bad debts taken in a year before the stock or debts actually become worthless have "no basis in law or fact" and, therefore, are "grossly erroneous" deductions for purposes of the innocent spouse relief provisions of Section 6013(e) of the Internal Revenue Code of 1954, as amended by Congress by the deficit Reduction Act of 1984.

2. Whether the petitioner is entitled to "innocent spouse" relief from understatements of income tax resulting from disallowed deductions for bad debts and worthless stock taken by her now deceased former spouse from whom she was divorced in 1982 on their joint personal income tax returns for 1977 and 1978.

3. Whether the United States Court of

Appeals for the Sixth Circuit ("Sixth Circuit") erred in its analysis of the United States Court of Appeals for the Eighth Circuit's ("Eighth Curcuit") definition of "no basis in fact or law" as applied to bad debt and worthless stock deductions in the Eighth Circuit's decision in Shenker v. Commissioner, 804 F. 2d 109 (8th Cir. 1986), cert. denied, 107 S. Ct. 2460 (1987).

4. Whether the innocent spouse provisions of Section 6013(e) of the Internal Revenue Code are to be strictly contrued against the taxpayer asserting protection thereunder as has been done in this case by the United States Tax Court (Tax Court) and the Sixth Circuit or is to be more expansively construed in favor of the taxpayer, as has been done by the Eighth Circuit.

PARTIES

Joyce Purcell, Petitioner-Appellant

Commissioner of Internal Revenue,

Respondent-Appellee

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit is reported at 87-2 USTC 9474, 60 AFTR 2d 87-5138 (CA-6, 1987), and is copied in Appendix A hereto, infra, page 26. The opinion of the United States Tax Court is copied in A hereto, infra, page 55 and is reported at 86 TC 228; Dec. 42, 894.

GROUNDS FOR JURISDICTION

The jurisdiction of this Court is invoked on the following grounds:

1. The date of the judgment of the United States Court of Appeals for the Sixth Circuit sought to be reviewed is August 18, 1987.

2. The order of the United States Court of Appeals for the Sixth Circuit denying the petitioner-appellant's timely petition for rehearing en banc was filed

October 5, 1987. The petitioner was before the Court of Appeals seeking review of the decision of the United States Tax Court entered on April 24, 1986.

3. The jurisdiction of the Court is invoked under 28 U.S.C. §1254(1), and Rule 17.1(a) and (c) of the Rules of the Supreme Court of the United States.

STATUTES AND REGULATIONS

The statutes and regulations which the case involves are as follows:

Internal Revenue Code of 1954, as amended, §165(a):

(a) General Rule - There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Internal Revenue Code of 1954, as amended, §165(g):

Worthless Securities

(1) General Rule - If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security Defined - For purposes of this subsection, the term "security" means -

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest

coupons or in registered form.

Internal Revenue Code of 1954, as amended, §166(d):

Nonbusiness Debts -

(1) General Rule - In the case of a taxpayer other than a corporation -

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness Debt Defined - For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than -

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Internal Revenue Code of 1954, as amended, §6013(e), as amended by the Deficit Reduction Act of 1984:

(e) Spouse relieved of liability in certain cases

1. In general under regulations prescribed by the Secretary, if --

(A) a joint return has been made under this section for a taxable year,

(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one

spouse,

(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

2. Grossly erroneous items. For purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse --

(A) any item of gross income attributable to such spouse which is omitted from gross income, and

(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

3. Substantial understatement. For purposes of this subsection, term "substantial understatement" means any understatement (as defined in §661(b)(2)(A)) which exceeds $500.00.

Treasury Reg. §1.166-5(a)(2) -

(a) Allowance of deduction as capital loss.

(2) If, in the case of a

taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such a loss is subject to the limitations provided in §1211, relating to the limitation on capital losses, and §1212, relating to the capital loss carryover, and in the regulations under those sections. A loss on a

nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

STATEMENT OF THE CASE

Petitioner requests the Court to review the decision of the United States Court of Appeals for the Sixth Circuit affirming the United States Tax Court's redetermination of an income tax deficiency of Petitioner for the calendar years 1977 and 1978.

The matter was originally before the Tax Court pursuant to Section 6213(a) of the Internal Revenue Code of 1954, as

amended (the "Code"), by reason of a timely filed Petition requesting a redetermination of a federal income tax deficiency originally determined by the Commissioner of Internal Revenue.

This civil controversy involves tax in the amount of $66,871.00, for the year 1977, and $35,340.75, for the year 1978, making a total of $102,211.75, plus statutory interest. At issue is whether Petitioner, Joyce Purcell, is an innocent spouse and, therefore, not liable for substantial understatements of income tax returns for the years 1977 and 1978. Petitioner was divorced from Bruce Purcell in October, 1982. He died in July, 1983, after having married one of the women with whom he had extra-marital involvement during and after the tax years in question. Petitioner has a high school education and was a homemaker during all of the pertinent years.

The United States Court of Appeals for the Sixth Circuit (the "Sixth Circuit") affirmed the United States Tax Court's (the Tax Court") redetermination of the income tax deficiency originally determined by the Commissioner of Internal Revenue (the Commissioner"). The Tax Court found that Petitioner is an innocent spouse as to certain items of omitted gross income attributable to her former spouse, but denied relief from interest and covenant not to compete income resulting from the sale of stock in a corporation known as Reese Tire Company. The Tax Court also denied innocent spouse relief as to deductions for bad debts and worthless stock taken on the joint returns for the years 1977 and 1978. Petitioner timely appealed to the Sixth Circuit from the decision of the Tax Court.

In light of the Sixth Circuit's

finding that material evidence in the record supported the Tax Court's conclusion that Petitioner knew of the sale of Reese Tire Company stock, Petitioner restricts her request for review in this Court to the issues regarding deductions taken for bad debts and worthless stock.

Petitioner unsuccessfully asserted in the Tax Court and the Sixth Circuit that she is entitled to innocent spouse relief because the deductions for bad debts and worthless stock had "no basis in law or fact", even though worthlessness might be established in some subsequent year.

In the proceedings in the Sixth Circuit, the legal argument advanced on behalf of Petitioner relied heavily on the opinion of the United States Court of Appeals for the Eighth Circuit ("the Eighth Circuit") in Shenker, 804 F.2d at

109. Shenker was the only precedent available at the time of the argument before the Sixth Circuit on the definition of "no basis in fact or law" regarding worthless stock deductions in the context of the rules for relief as an innocent spouse.

ARGUMENT FOR ALLOWING THE WRIT

The Court has not considered the issues presented by this case. The Deficit Reduction Act of 1984 expanded the innocent spouse relief provisions but left undefined certain key terms which have been the center of controversy in the proceedings giving rise to this petition and in other proceedings affecting other taxpayers.

Specifically, Internal Revenue Code Section 6013(e), as amended in 1984, does not define "no basis in fact or law", and

the issue has never been before this Court. Only two Circuit Courts of Appeal have considered the issue, and they have reached substantially contrary conclusions.

There is an apparent split between the Sixth Circuit and the Eighth Circuit on the interpretation of the term "no basis in fact or law" in determining whether untimely income tax deductions for worthless stock and bad debts, are "grossly erroneous" in the context of relief to innocent spouses. It appears that the Sixth Circuit has adopted a very strict interpretation of the statutory language.

The Eighth Circuit Court of Appeals in its Shenker decision appears to have interpreted the relief provisions as applied to worthless stock deductions more expansively. The Eight Circuit found that

there was "no basis in fact or law" for a worthless stock deduction taken in a year in which the stock did not in fact become worthless. This is true even if worthlessness is established for a subsequent year. Innocent spouse relief was accorded that taxpayer. Shenker, 804 F.2d at 109.

Nevertheless, under analogous circumstances, innocent spouse relief has been denied the petitioner in the Sixth Circuit, even though the stock and debts involved did not become worthless in the year in which the deduction was taken. The Sixth Circuit determined that there was "some basis" for the otherwise untimely deduction, and refused to follow the reasoning of the Eighth Circuit's Shenker decision.

Petitioner relied on the decision of the Eighth Circuit in her appeal to the

Sixth Circuit from an adverse ruling on the same issue in the Tax Court. Petitioner had unsuccessfully urged the Tax Court to adopt the rationale which was subsequently adopted by the Eighth Circuit in Shenker in granting innocent spouse relief to another taxpayer.

The disparate interpretation of the law between the Sixth Circuit and the Eighth Circuit argues strongly in favor of a clear interpretation of the statute by this Court. Precedent is needed on which taxpayers, tax collectors and the courts may rely for more uniform and proper resolution of disputed income tax deficiency determinations.

This important federal statute question should also be considered by the Court to prevent frustrating the congressional intent to expand the innocent spouse relief provisions.

Commentators in tax journals and periodicals have generally noted that the courts appear to be applying such strict standards for relief that the purpose of the 1984 statute is not being realized. See, Borison, Innocent Spouse Relief: A Call for Legislative and Judicial Liberalization, 40 The Tax Lawyer 818, 822-23 and 842-60 (1987); Comment, Court Takes Strict View of Innocent Spouse Status, 15 Estate Planning 29, 29--30 (1988).

In Shenker, the Eighth Circuit determined that the timing of the deduction is important to a determination of whether the deduction has a basis in fact or law for the year in which it was taken. The Sixth Circuit ruled to the contrary, saying that some basis for deduction could be found if the question is only one of the timing of the deduction, i.e., the year in which the

stock or debt actually became worthless. In a concurring opinion, Judge Jones of the Sixth Circuit states that the Court should simply conclude that the Eighth Circuit's analysis is wrong. The Sixth Circuit would only allow "phony" or fraudulent deductions to be defined as grossly erroneous.

The effect of the Sixth Circuit's opinion is to include within the qualifying provisions of the "innocent spouse rule" a requirement that the party claiming "innocent spouse" status establish fraudulent intent on the part of the non-innocent spouse. This burden is not placed by the Code, but by the Court and is clearly a burden which can seldom be carried.

For the foregoing reasons, this Court is urged to grant the Writ of Certiorari and to resolve the conflict between the

Circuit Courts of Appeal by deciding this important question of federal law.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and exact copy of this pleading has been served upon all parties at interest in this case or counsel therefore by delivering said copy to said person, his office, or by placing said copy in the United States Mail, addressed to the last known address of said person with sufficient postage thereupon to carry the same to its destination.

This 31st day of December 1987

GARNER, LEWIS, CATES & PRICKETT

By Alan L. Cates

cc: Roger Olsen, Esq.
Michael Paup, Esq.
Gilbert Rothenberg, Esq.
Teresa McLaughlin, Esq.

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APPENDIX A

No. 86-1678

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

JOYCE PURCELL, Petitioner-Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	ON APPEAL from the UNITED STATES TAX COURT

Decided and Filed August 18, 1987

Before KENNEDY, JONES and RYAN, Circuit Judges.

KENNEDY, Circuit Judge. Purcell ("appellant") appeals the decision of the tax court upholding the Commissioner's assessment of an income tax deficiency for the tax years 1977 and 1978. The tax court concluded that section 6013(e) of the Internal Revenue Code, the innocent spouse provision, did not relieve appellant from liability for the tax

resulting from allocation of a portion of the proceeds from the sale of appellant's stock in a corporation to a covenant not to compete because appellant had actual knowledge of the covenant. The tax court also concluded that the innocent spouse provision did not relieve appellant from liability for income tax resulting from the disallowance of claimed bad debt and worthless stock deductions because appellant did not establish that these deductions were grossly erroneous. We affirm.

Appellant and Ira Reese owned the stock in Reese Tires, Inc. W. Bruce Purcell, appellant's husband, who is now deceased, actively managed the company. On April 15, 1977, appellant, her husband, and Ira Reese entered into an agreement to sell the stock in Reese Tires to Universal Tire, Inc. Reese and Mr. Purcell negotiated this sales agreement; appellant

did not participate in the negotiations. Nevertheless, appellant did sign the agreement and initialled it in several places where its terms were altered. One such change was in a clause agreeing that appellant, her husband, and Reese would not compete with Universal Tire in the tire business for three years in specified locations. Appellant initialled a portion of the agreement that changed this covenant from five years to three years.

Appellant and her husband were married in 1952 and divorced in 1982. They filed joint federal income tax returns for 1977 and 1978. During these years, appellant and her husband were stockholders and employees of Purcell Enterprises, Inc. Appellant's duties in this corporation were limited to signing checks on the corporate bank account when Mr. Purcell was out of town and typing and clerical work when her services were required.

Appellant also made occasional charges on the company's credit card.

During 1977 and 1978, appellant and her husband each owned twenty-five percent of the outstanding stock of International Demolition and Salvage Co., Inc. ("International Demolition"), a corporation formed in February, 1974. Appellant was the treasurer of this corporation and a director in 1977 and 1978. Her husband and other shareholders made advances to International Demolition in 1976, 1977, and 1978. This money was treated on the corporate books as loans to the corporation. In 1980, Mr. Purcell transferred his stock in International Demolition to a third party for $10.00 pursuant to an agreement providing that this third party would assume the management and debts of the corporation.

A certified public accountant prepared

the joint tax return for the years in question. Appellant furnished only information relating to medical expenses, charitable contributions, and other types of personal items to the CPA for use in preparing the returns. The CPA received most of the information used in preparing the returns from the comptroller of Purcell Enterprises, who was also the comptroller of International Demolition. The CPA occasionally requested information from Mr. Purcell if the comptroller could not furnish the information. The CPA testified that at the time he prepared the returns, he believed he had sufficient information to prepare the returns correctly and made no audit of appellant or Mr. Purcell's records. Appellant did not review the returns prior to signing.

On their joint federal income tax returns for 1977 and 1978, appellant and her husband claimed deductions for

nonbusiness bad debts from Reese Tires in the respective amounts of $17,500 and $5,298.69. They also claimed deductions for nonbusiness bad debts with respect to International Demolition in the amounts of $144,411.26 for 1977 and $95,185.05 for 1978. The Commissioner, in the notice of deficiency, disallowed these deductions because it was not established that these debts became worthless in the years in which the losses were claimed. Appellant and her husband also reported that they had sustained a long-term capital loss during 1977 in the amount of $26,904.85 because of the worthlessness of their stock in International Demolition. The Commissioner also disallowed this deduction because it was not established that the stock became worthless 1977. Finally, the Commissioner increased their reported income by $15,300 for 1977 because this amount was the amount of the

sale price of the Reese Tires stock attributable to the covenant not to compete.

Appellant filed a petition for redetermination of these deficiencies in the tax court. Although conceding that the adjustments were correct, appellant contended that she should be afforded relief as an innocent spouse under section 6013(e) of the Internal Revenue Code. With respect to the income derived from the covenant not to compete, the tax court held that section 6013(e) did not provide appellant with relief inasmuch as she had knowledge of the provision in the sales agreement. Although the court recognized that she did not participate in the negotiations for the sale of Reese Tires, she owned the stock and was a signatory to the contract. Further, the court emphasized that appellant initialled a change in the years for which the

covenant was effective. Although the court noted that appellant did not know the tax consequences of the covenant, it stated that the knowledge contemplated by section 6013(e)(1)(C) is not knowledge of the tax consequences of a transaction but knowledge of the transaction itself. See, e.g. Quinn v. Commissioner, 524 F.2d 617, 626 (7th Cir. 1975).

With respect to the worthless stock and bad debt deductions, the court found that appellant did not know that these items were taken as deductions. Nevertheless, the court held that she did not meet her burden of proof that these deductions were "grossly erroneous" as defined in section 6013(e)(2).[1] The court noted that International Demolition was in

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[1] The court stated that appellant's concession that the Commissioner's adjustment for these deductions was correct was insufficient to establish that the deductions were "grossly erroneous."

poor financial condition during the years in question and that the CPA testified that at the time he prepared the returns he believed that all items were accurate. The court further noted that the CPA relied on information supplied by the comptroller of Purcell Enterprises and International Demolition.

I.

Section 6013(d)(3) of the Internal Revenue Code provides that when a joint return is filed, the parties are jointly and severally liable for the amount of tax due. One exception to this rule is the innocent spouse provision contained in section 6013(e).[2] This section provides that a spouse is relieved from liability

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[2] Section 6013(e), as amended by the Deficit Reduction Act of 1984, provides in pertinent part:

(e) Spouse relieved of liability in certain cases.

where, on a joint return, there is a

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(1) In general.

Under regulations prescribed by the Secretary, if -

(A) a joint return has been made under this section for a taxable year,

(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

(2) Grossly erroneous items.

For purposes of this subsection, the term "Grossly erroneous items" means, with respect to any spouse -

substantial understatement[3] of tax attributable to grossly erroneous items,

(A) any item of gross income attributable to such spouse which is omitted from gross income, and

(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

Deficit Reduction Act of 1984, Pub. L. No. 98-369, §424(a), 98 Stat. 494, 801-02 (1984) (current version at 26 U.S.C. §6013(e) (Supp. III 1985)). Section 2 of the Tax Reform Act of 1986, Pub. L. No. 99-514, §2 (1986), has redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986. Nevertheless, the years at issue in the present case antedate the Tax Reform Act of 1988.

Section 424(c) of the Deficit Reduction Act renders the amendment to section 6013(e) of the Code applicable to all taxable years to which the Internal Revenue Code of 1954 applied.

[3] Section 6013(e)(3) defines substantial understatement as a liability in excess of $500. Section 6013(e)(4) further provides that in the case of liability not attributable to an omission of an item of gross income, the understatement of tax must also exceed a specified percentage of the spouse's adjusted gross income for the preadjustment year. In the present case, it is undisputed that the understatement of income for both years was substantial.

if the other spouse establishes that in signing the return, he or she did not know, and had no reason to know, that there was such substantial understatement, and, taking into account all the circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax attributable to such substantial understatement. This Court has held that the taxpayer has the burden of proof with respect to all requirements of section 6013(e). Shea v. Commissioner, 780 F.2d 561, 565 (6th Cir. 1986). The statute further provides that any understatement of tax attributable to omitted income is considered grossly erroneous. Understatements of tax attributable to deductions, on the other hand, are "grossly erroneous items" only if the deductions have "no basis in fact or law."

II.

The tax court concluded that appellant

was not entitled to relief with respect to the tax resulting from the income from the portion of the sale price of Reese Tires stock allocated to the covenant not to compete because appellant had actual knowledge of the transaction that gave rise to the omission of income. Whether appellant know of the substantial understatement of tax on the joint return is a question of fact subject to the clearly erroneous standard of review. ID. Appellant testified that her husband informed her that they were selling Reese Tires, and she admitted signing the agreement. Appellant initialled her consent to a handwritten change in the covenant reducing its term from five to three years. There was ample basis for the tax court to find that she knew that the noncompetition provision was in the contract. Furthermore, the tax court's conclusion that her awareness of the tax

consequences of this transaction was immaterial is correct. As the Seventh Circuit stated: "[t]he knowledge contemplated by [section 6013(e)] is not knowledge of the tax consequences of a transaction but rather knowledge of the transaction itself." Quinn v. Commissioner, 524 F.2d 617, 626 (7th Cir. 1975)(citation omitted).[4] Thus, we believe that the court correctly concluded that appellant was not entitled to relief from the deficiency resulting from the income derived from the covenant not to compete.

III.

Prior to the 1984 amendments, section

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[4] Appellant relies incorrectly on this Court's decision in Shea in support of her argument that the tax court applied the incorrect legal standard for determining whether she did not know and had no reason to know that there was a substantial understatement of income. Unlike the situation in the present case, the tax court in Shea concluded that the taxpayer had no actual knowledge of the understatement. Shea, 780 F.2d at 565.

6013(e) provided no relief where the understatement of tax was attributable to claimed deductions. With the 1984 amendments, Congress extended the term "grossly erroneous items" to apply to claims of deductions, credits or bases for which there is no basis in law or fact that give rise to a substantial understatement of taxable income. H. Rep. No. 98-432, Pt. 2, 98th Cong., 2d Sess. 1502, reprinted in 1984 U.S. Code Cong. & Admin. News 694, 1143. The tax court in the present case concluded that appellant did not qualify for relief under section 6013(e) with respect to the nonbusiness bad debt and worthless stock deductions because this understatement of tax was not attributable to "grossly erroneous items" as so defined because appellant failed to demonstrate that there was no basis in fact or law for the deductions.

Relying on Shenker v. Commissioner,

804 F.2d 109 (8th Cir. 1986), cert. denied, 107 S. Ct. 2460 (1987), appellant contends that whenever the taxpayer has had no loss, or the loss did not occur in the tax year for which the taxpayer claimed it, the deduction has no basis in fact or law and is therefore grossly erroneous. In Shenker, the tax court disallowed a deduction claimed on the taxpayers' 1971 joint tax return for the loss of securities held on Mr. Shenker's account at a brokerage firm that he was unable to recover when this firm went bankrupt in 1972. The tax court found that under section 165 of the Internal Revenue Code, which permits deductions only for losses "sustained during the taxable year," Mr. Shenker was not entitled to claim the deduction in 1971 because he suffered the loss in 1972. The company remained viable until forced into liquidation in 1972, and Mr. Shenker never demanded return of the

stock until June, 1972. Nevertheless, the tax court concluded that Mrs. Shenker was not entitled to innocent spouse relief because the loss occurred at some point, the issue was merely one of timing, and therefore the deduction was not grossly erroneous.

The Eighth Circuit reversed, stating:

> Section 165(a) permits deductions only for losses "sustained during the taxable year." Therefore, for there to be some "basis in fact or law," §6013(e)(2), for a deduction under §165(a), there must be some basis not only for claiming that a loss occurred, but also for claiming that it was sustained during the taxable year in question. In the present case, the findings of the Tax Court discussed above make clear that there was simply no basis upon which Mr. Shenker could claim that the loss of his stock occurred in 1971, rather than some later year. We therefore reverse the decision of the Tax Court on this issue, and remand the case for consideration of whether Mrs. Shenker meets the remaining requirements for relief under §6013(e).

804 F.2d at 115

We believe appellant misreads the

Eighth Circuit's holding in Shenker when she asserts that all she need show is that the loss did not occur in the taxable year in question. Rather, the court first pointed out that section 165 requires that a deduction may be taken only if a loss has occurred and also that it was sustained during the tax year in question. It seems then to discuss some "basis in law and fact," apparently to contrast "some" to "no" basis as required by section 6013(e)(2). It then concludes that in the case before it there was simply no basis for claiming the deductions in 1971, the tax year in question, and the innocent spouse was therefore entitled to relief if she met the remaining requirements of the section. Had there been some basis for claiming the loss was sustained in 1971, we believe the Eighth Circuit would reach the result that we do here and deny relief.

The purpose of the innocent spouse rule is to protect one spouse from the overreaching or dishonesty of the other. Where there is an arguable factual or legal basis for claiming the deduction in the tax year for which the return is filed, it is likely that a fully informed spouse would have joined in the return. To adopt the rule advocated by appellant would place the uninformed spouse in a superior position since it would only be necessary to show that the deduction was improperly taken during the return year. Furthermore, appellant's position would result in reading out the requirement in section 6013(e)(2)(B) that there must be no basis in fact or law for the deduction, credit, or basis.

Appellant contends that the debts and stock in the present case were not wholly without value in the years in which the deductions were taken. With respect to the

bad debts, appellant contends that Mr. Purcell did have a reasonable prospect of payment in the years in which the deduction were taken.[5] The tax returns for International Demolition for 1978 and 1979 showed an operating profit before applying the net operating loss carryover. Furthermore, International Demolition continued to carry the debts on its books as debts to shareholders. With respect to the worthless stock deduction, appellant contends that the record before the court demonstrated that the stock did not become totally worthless in 1977. Mr. Purcell and other International Demolition stockholders also loaned money to this company in 1976, 1977, and 1978.

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[5] Appellant contends that the test for a proper bad debt deduction is similar to the worthless stock deduction - the debt must have had some worth at the beginning of the tax year and no worth at the end of the tax year. Treas. Reg.§1.166-5(a)(2) (1986).

Furthermore, International Demolition did not fail until several years after the year in which the worthless stock deduction was taken. Pointing to this information, appellant disagrees with the court's conclusion that she made no showing that these deductions had no basis in fact or law. Appellant also points out that the CPA who prepared the returns testified that he did not do any investigation into the information supplied to him; thus the tax court erred in assuming that the CPA satisfied himself as to the accuracy of the information on the returns.[6]

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[6] Appellant also argues that she met the other criteria for the innocent spouse exception to the joint and several liability rule. Nevertheless, the tax court concluded that she could not qualify for the exception with respect to the bad debt and worthless stock deductions because she had not shown that these deductions were grossly erroneous. Furthermore, the court held that she did

The statute does not define "no basis in fact or law." The only legislative history with respect to this issue is contained in a House committee report. The report states that a spouse may be entitled to relief where, for example, one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony. H. Rep. No. 98-432, Pt 2, 98th Cong., 2d Sess. 1502, reprinted in 1984 U.S. Code Cong. & Admin. News 694, 1143. In other cases, the tax court has interpreted the term "grossly erroneous items" to mean deductions or credits that are "fraudulent," "frivolous," "phony," or "groundless" E.g.

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not meet the exception with respect to the income derived from the covenant not to compete because she knew of the transaction. Therefore, this Court will not consider whether appellant met the other criteria of the innocent spouse provision.

Douglas v. Commissioner, 86 T.C. 758 (1986); Sivils v. Commissioner, 86 T.C. 79 (1986).

We believe that the tax court's conclusion that appellant failed to meet her burden of proving that the deductions had no basis in fact or law is correct. The court found that International Demolition was in financial straits during 1977 and 1978. The corporation paid no salaries to officers after 1977, after paying approximately $49,000 in 1976 and $4,400 in 1977. Additionally, the corporation's net operating losses increased from $434,280.59 in 1975 to $964,304.64 in 1978 and the value of its assets (exclusive of liabilities) declined from $1,285,113.40 in 1975 to $268,958.01 in 1978. Corporate assets consisting of buildings, furniture, and equipment were liquidated in 1977 and 1978. Finally, although International Demolition reported

operating profits in 1978 and 1979, these profits apparently resulted from recapture of depreciation on the disposition of corporate assets.[7] Thus, there was both an arguable factual and legal basis for claiming them in the tax year in which they were taken.

IV.

Accordingly, the judgment of the tax court is AFFIRMED.

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[7] Appellant points to nothing in the record regarding the invalidity of the deductions attributable to bad debts owed by Reese Tires. Appellant may not rely on the disallowance or her inability to substantiate the deduction alone to prove a lack of basis in fact or law.

JONES, Circuit Judge, concurring. I concur in today's affirmance of the tax court's decision denying appellant relief under the "innocent spouse" provision of the Internal Revenue code, 26 U.S.C. §6013(e) (Supp. III 1985). I write separately only to register my disagreement with court's attempt to distinguish the recent decision in Shenker v. Commissioner, 804 F.2d 109 (8th Cir. 1986), cert. denied, 107 S. Ct. 2460 (1987). With all due respect, it is my view that we should reject outright the Eighth Circuit's analysis of section 6013(e) as an erroneous interpretation of an admittedly counter-intuitive provision of the Code.

As Judge Kennedy notes, the clause immediately preceding section 6013(e) provides that, when a joint return is filed, both spouses are jointly and severally liable for the amount of tax due

on the aggregate income. 26 U.S.C. §6013(d)(3)(1982). However, if "there is a substantial understatement of tax attributable to grossly erroneous items of one spouse," id. §6013(e)(1)(B) (emphasis added), the innocent spouse may escape liability for the tax, interest and penalties attributable to such understatement of the remaining requirements of subsection (e)(1) are satisfied. Where the understatement of tax is attributable to a disallowed deduction, the Code provides that it will be deemed 'grossly erroneous" if there "is no basis in fact or law" for the claimed deduction. Id. §6013(e)(2)(B).

Again, as Judge Kennedy observes, the tax court has taken the position that for a claimed deduction of one spouse to be "grossly erroneous" under section 6013(e)(1)(B), it must be "fraudulent," "frivolous," "phony," or "groundless." As

the tax court recently explained:

> [I]t simply does not follow that because deductions lacking in a factual or legal basis will be disallowed, all deductions which are disallowed lack a factual or legal basis. Petitioner may not rely on the disallowance or her inability to substantiate the deductions alone to prove a lack of basis in fact or law.

Douglas v. Commissioner, 86 T.C. 758, 763 (1986). I agree with this reading of the statute.

By contrast, the Eighth Circuit in Shenker seemingly rejects this analysis. By looking to section 165(a) and (g), 26 U.S.C. § 165(a),(g) (1982), for the Code's explanation of the deductibility of worthless stock,[1] the Shenker court has equated the nondeductibility of a claimed loss with the conclusion that a deduction

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[1] The concomitant provision for the deductibility of bad nonbusiness debts is found at 26 U.S.C. §166(d) (1982 & Supp. III 1985).

taken for that loss has "no basis in fact or law." In other words, according to the Eighth Circuit, a claimed deduction for worthless stock or bad nonbusiness debts that is disallowed under sections 165 or 166 is, necessarily, "grossly erroneous" for purposes of section 6013(e)(1)(B) and (e)(2)(B).

I do not think that the term "grossly erroneous" deduction can or should be defined simply as an "erroneous" deduction. Such a reading would render superfluous not only the adverb "grossly" but the entire concept of "grossly erroneous deduction," since no would-be innocent spouse seeks relief from an approved deduction. In this manner, the Shenker interpretation substantially undermines the integrity of the presumption of joint and several liability expressed in section 6013(d)(3), and provides a practical incentive for spouses to remain ignorant

of each other's business dealings as well as the various items on their joint tax returns.

I would reject the Shenker court's interpretation of the innocent spouse provision and embrace the analysis set forth in the tax court's cases.

UNITED STATES TAX COURT

JOYCE PURCELL, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 27793-83 Filed February 26, 1986.

Held: On the fact of record petitioner is entitled to relief under section 6013(e), I.R.C. 1954, with respect to certain items of omitted income and is not entitled to such relief with respect to another item of omitted income. Petitioner is not entitled to relief under section 6013(e) for disallowed deductions since not contesting respondent's disallowance of the deductions is not sufficient to establish

that the deduction were "grossly erroneous" because they had no basis in fact or law.

Alan L. Cates, for the petitioner.

Robert P Crowther, for the respondent.

SCOTT, Judge: Respondent determined deficiencies in petitioner's income tax for the calendar years 1977 and 1978 in the amounts of $82,955.89 and $49,749.21, respectively. The issue for decision is whether petitioner is relieved from liability under section 6013(e)[1] with respect to the income tax resulting from (1) the inclusion in the income of petitioner and her then husband of (a) dividends resulting from amounts paid by a corporation of which they were stockholders for personal travel and entertainment expenses, and (b) a portion of the sales price of petitioner's stock in another corporation allocated to a covenant not to compete; and (2) the disallowance of claimed bad debt and

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[1] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years here in issue.

worthless stock deductions with respect to a third corporation in which both petitioner and her then husband owned stock.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner who resided in Franklin, Tenessee, at the time of the filing of her petition in this case, filed a joint Federal income tax return with her then husband, W. Bruce Purcell for each of the calendar years 1977 and 1978 with the Director, Internal Revenue Service Center, Memphis, Tennessee. For the calendar year 1977, they filed an amended Federal income tax return on Form 1040X.

Petitioner and W. Bruce Purcell were married on July 23, 1952, and were divorced in October 1982. W. Bruce

Purcell died, by accidental drowning, in July 1983. During the years 1977 and 1978, both W. Bruce Purcell and petitioner were stockholders and employees of Purcell Enterprises, Inc. This company was run primarily by Mr. Purcell, and petitioner's duties were limited to signing checks on the corporation's bank account when Mr. Purcell was out of town and some typing and clerical work when her services were needed in the office. She did not deal with the corporate customers. The company had an American Express account and each of the officers of the company, including Mr. Purcell, had an American Express Card in his name on this account. Petitioner had a company American Express Card in her name, permitting her to make charges the account of Purcell Enterprises, Inc.

Petitioner occasionally accompanied her husband on trips and at his request

charged the cost of the hotel room that she and her husband used and other costs of the trip on the corporate American Express Card issued in her name. Other than the charges made on the card at her husband's request, petitioner made only a few charges on the company American Express Card. Occasionally she made other charges on this card and did not keep a record or diary of the charges she made. Petitioner discussed the use of this card with Mr. Purcell and was told by him that he would take care of the charges she made for personal purposes, because the corporation always owed him money. Petitioner charged a few meals in Nashville to this credit card and charged lodging in Knoxville, where her children were in school, to this credit card. Petitioner also charged a small purchase of foreign currency to this credit card.

In February 1974, a corporation,

International Demolition and Salvage Co., Inc. (International Demolition), was formed under the laws of the State of Tennessee. During the years 1977 and 1978, petitioner and W. Bruce Purcell each owned 25 percent of the outstanding stock of International Demolition. Petitioner was treasurer of International Demolition during 1977 and 1978 and was a corporate director in these years. International Demolition had a sustained history of losses throughout its existence. It was in financial difficulties in 1977 and 1978 and ultimately failed. Petitioner's then husband, W. Bruce Purcell, and other shareholders of International Demolition infused money into the corporation in 1976, 1977 and 1978, which monies were treated on the corporate books as loans to the corporation.

Reese Tires, Inc., was a corporation the stock of which was owned by petitioner

and Mr. Ira Reese. As of April 15, 1977, petitioner owned 560 shares of the stock of Reese Tires, Inc., and Mr. Reese owned 480 shares of the stock of that corporation. Under date of April 15, 1977, petitioner, W. Bruce Purcell and Ira Reese entered into an agreement to sell petitioner's and Mr. Reese's stock in Reese Tires, Inc., to Universal Tire, Inc., a Tennessee corporation. The sales agreement was negotiated by Mr. Purcell and Mr. Reese. Petitioner did not participate in the negotiation for the sale of the stock of Reese Tires, Inc., to Universal Tire, Inc. However, she did sign the agreement and initialed the agreement in several places where changes were made. One of the changes initialed by petitioner was in a clause agreeing that neither petitioner, Mr. Purcell nor Mr. Reese would compete with Universal Tire, Inc., in the tire business for a

period of 3 years in specified locations. One of the changes made in the agreement by pen, which was initialed by petitioner, was changing 5 years to 3 years in this clause of the agreement.

The income tax returns of petitioner and her then husband for the years 1977 and 1978 were prepared by a certified public accountant. Except for certain items of medical expenses and charitable contributions and other types of personal items, none of the information used in the preparation of the returns was furnished to the CPA by petitioner. Most of the information used by the CPA in preparing the joint returns of petitioner and her then husband for the years 1977 and 1978 was obtained by the CPA from a Mr. John H. Moses who was the comptroller of both Purcell Enterprises, Inc., and International Demolition. If the CPA needed additional information or to

clarify information he had, generally he would ask a question of the comptroller and if the comptroller could not answer the question, he would attempt to get the information from Mr. Purcell. The CPA very seldom consulted with Mr. Purcell and did not consult at all with petitioner. When the CPA prepared the returns, he was of the opinion that he had sufficient information to prepare the returns correctly. The CPA made no audit of the records of petitioner or Mr. Purcell in preparing their individual income tax returns, but prepared the returns from information furnished to him. Petitioner did not review the returns prepared by the CPA.

Petitioner personally guaranteed certain notes of her then husband, W. Bruce Purcell, to banks in Nashville, Tennessee, for loans made to him.

Petitioner's primary occupation was a housewife. She married Mr. Purcell shortly after she graduated from high school. She worked after they were married to assist Mr. Purcell with his college education. When petitioner signed the guarantees of her husband's loans, he told her that his businesses had sufficient assets to pay off these business debts.

There were problems in connection with petitioner's marriage during 1977 and 1978. Mr. Purcell was away from home during much of the time in these years and was drinking heavily. He also was seeing the woman whom he married after he and petitioner were divorced in 1982.

In the divorce decree a recitation is made that petitioner and Mr. Purcell had lived apart since 1979. In the divorce decree there was incorporated a property

settlement agreement between petitioner and Mr. Purcell. In the property settlement agreement, petitioner received the family home, which was free and clear at the time, and the furnishings of that home. She also received an automobile. The agreement provided for certain cash payment by Mr. Purcell to petitioner over a period of 121 months. Paragraph 7 of the agreement provided as follows:

> 7. That HUSBAND shall keep in full force and effect and pay all necessary premiums for three (3) certain policies of insurance with the New York Life Insurance Company, being Policy Numbers 33-002-776, 36-402-141, and 36-426-995, in the total face amount of Nine Hundred Thousand ($900,000.00) Dollars, which policies of insurance are owned by and payable to WIFE as beneficiary to secure this agreement, and further HUSBAND shall keep in full force and effect and pay any and all necessary premiums for a major medical hospitalization insurance program in at least the amount of Fifty Thousand ($50,000.00) Dollars and both collision and liability insurance for WIFE in the operation of any vehicle or conveyance of any nature whatsoever in at least the amount of Three Hundred Thousand ($300,000.00) Dollars until death or remarriage of WIFE or for said One Hundred Twenty-One months from July 1, 1982 to July 1, 1992.

The property settlement agreement also transferred to petitioner 15 cemetery lots in Woodlawn Memorial Park in Nashville, Tennessee, and Mr. Purcell's interest in 6 parcels of real estate specifically described in the agreement, some of which were owned jointly by Mr. Purcell and others. The agreement provided that Mr. Purcell would execute a note in the amount of $121,000 to petitioner to secure the payment of the principal sum of $121,000 as periodic alimony in monthly installments of $1,000 each for 121 months, beginning on July 1, 1982, and continuing through July 1, 1992, unless petitioner dies or remarries prior to the date of the last payment. The property settlement agreement also provided for the transfer by Mr. Purcell of certain certificates of stock in the bank of Maryville, Tennessee, to petitioner. The only property granted to Mr. Purcell by

the agreement, other than his personal effects which he was to remove from the family residence, was all right, title, and interest which petitioner had in any business interests of Mr. Purcell, including but not limited to Purcell Enterprises, Inc. Mr. Purcell assumed the responsibility and liability for all outstanding debts and bills with respect to his business operations, particularly including indebtedness to the Third National Bank of Nashville, Tennessee, and the Continental National American Insurance and Bonding Co. with regard to the bonding of construction contracts in Mr. Purcell's business. Mr. Purcell agreed to hold petitioner harmless with respect to all indebtednesses which he had incurred or which were incurred in connection with his businesses.

Respondent in his notice of deficiency

increased the reported income of Mr. Purcell and petitioner by $17,750 in 1977 and $5,298.69 in 1978 as nonbusiness bad debts from Reese Tires, Inc., which were not allowable since it had not been established that they became worthless in 1977 or 1978. For the years 1977 and 1978, respectively, respondent increased petitioner's reported income by $144,411.26 and $95,185.05 because of disallowance of claimed deductions of bad debts of International Demolition on the ground that the debts did not become worthless in 1977 and 1978 or otherwise represent an allowable deduction, and also increased the reported income by $26,904.85 in 1977 by disallowance of a claimed long-term capital loss from worthless stock of International Demolition on the ground that it had not been established that the stock became worthless in that year. Respondent

increased the reported income of Mr. Purcell and petitioner by $28,258.10 in 1977 and $25,575.65 in 1978 with the explanation that the items represented dividends under sections 301 and 316 of the Internal Revenue Code because of benefits received from the permitted use of corporate property without compensation. The explanation of these items showed that in 1977, $7,675.08 was from personal use of aircraft and $20,583.02 from payment of personal travel and entertainment expenses and that in 1978, $8,681.03 was from personal use of aircraft and $16,894.62 from payments by Purcell Enterprises, Inc., of personal travel and entertainment expenses.

Respondent in 1977 increased Mr. Purcell's and petitioner's reported income by $15,300, explaining that this was the amount of the purchase price of the stock of Reese Tires, Inc., paid by Universal

Tire, Inc., for the purchase of a covenant not to compete and therefore should have been shown as ordinary income on the tax return. Respondent made a compensating adjustment in petitioner's 51 percent share of the payment from Universal Tire, Inc., which had been reported as gain from the sale of the stock. In addition, respondent made certain other minor adjustments with respect to interest deductions and a change in the amount of a bad debt loss which have not been placed in issue in this case.

Petitioner at the trial conceded that the adjustments made by respondent in the deficiency notice were correct for the purpose of this case, stipulating that--

> petitioner intends to limit her challenge to the adjustments made by the Commissioner in his notice of deficiency to whether I.R.C. sec. 6013(e), as amended by sec. 424 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 801-803, affords her relief as an innocent spouse.

At the trial petitioner's counsel stated that petitioner was unable to question the adjustments made by respondent because of lack of knowledge of the transactions.

OPINION

Section 6013(e), amended by the Tax reform Act of 1984, Pub. L. 98-369, sec. 424(a), 98 Stat. 801 (1984-3 C.B. 309),[2] provides that a spouse is relieved of

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[2] Sec. 6013(e), as amended by the Tax Reform Act of 1984, provides as follows:

(e) Spouse Relieved of Liability in Certain Cases.--

(1) In general.--Under regulations prescribed by the Secretary, if--

(A) a joint return has been made under this section for a taxable year,

(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

(C) the other spouse establishes

(footnote continued)

liability under regulations prescribed by the Commissioner where a joint return has been made for a taxable year and on that

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(footnote continued from previous page)

that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

(2) Grossly erroneous items.--For purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse--

(A) any item of gross income attributable to such spouse which is omitted from gross income, and

(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

(footnote continued)

return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse, if the other spouse establishes that in

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(footnote continued from previous page)
(3) Substantial understatement.--For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6661(b)(2)(A) which exceeds $500.

(4) Understatement must exceed specified percentage of spouse's income.--

(A) Adjusted gross income of $20,000 or less.--If the spouse's adjusted gross income for the preadjustment year is $20,000 or less, this subsection shall apply only if the liability described in paragraph (1) is greater than 10 percent of such adjusted gross income.

(B) Adjusted gross income of more than $20,000.--If the spouse's adjusted gross income for the preadjustment year is more than $20,000, subparagraph (A) shall be applied by substituting "25 percent" for "10 percent."

(C) Preadjustment year.--For purposes of this paragraph, the term "preadjustment year" means the most recent taxable year of the spouse ending before the date the deficiency notice is mailed.

signing the return she did not know, and had no reason to know, that there was such substantial understatement, and taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for the taxable year attributable to such substantial understatement.

Grossly erroneous items are defined to mean "any item of gross income attributable to such spouse which is omitted from gross income" and "any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law." Section 6013(e)(2)(A) and (B). Substantial understatement "means any understatement *** which exceeds $500." Section 6013(e)(3) .

There is a further provision requiring that the understatement must

exceed a specified percentage of the income for the pre-adjustment year of the spouse claiming the benefit of the statute. However, the parties in this case have stipulated facts which clearly show that petitioner's income for the pre-adjustment year was such that this requirement is met.

Respondent apparently admits that petitioner has met the requirements of section 6013(e), as amended, with respect to omission of income resulting from the determination of a dividend to petitioner's former husband because of personal use of an aircraft, although he argues generally that petitioner has failed to show that it would be inequitable to hold her liable for the total deficiency in this case.[3] Also,

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[3] Respondent in his brief states as follows:

(footnote continued)

respondent does not claim that the items on which petitioner claims relief as grossly erroneous items were not items of

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(footnote continued)

The fourth area of adjustment involves income realized by petitioner's husband from his personal use of an airplane maintained by Purcell Enterprises, Inc. The respondent concedes that the petitioner is an innocent spouse with respect to said income.

At the start of the trial the court asked whether it was respondent's view that a determination of innocent spouse status with respect to omitted income items could be made separately from a determination of innocent spouse status with respect to disallowed deductions, may be considered separately in determining whether petitioner is an innocent spouse.

Because of these two concessions by respondent, it is clear that respondent agrees with petitioner that under section 6013(e), as amended, individual items of income or deductions may be separately considered in determining whether there is a substantial understatement of tax attributable to grossly erroneous items of one spouse. Since petitioner approached her case on an item-by-item basis, we do not consider there to be an issue in this case as to whether different items of income and deduction may be separately considered in determining whether a taxpayer is entitled to any relief as an "innocent spouse."

Mr. Purcell. Respondent contends that petitioner either knew, or had reason to know, that Purcell Enterprises, Inc., was paying personal expenses of petitioner and her then husband. Respondent contends that petitioner did in fact know that there had been a covenant not to compete signed with respect to the sale of the stock of Reese Tires, Inc., and that all petitioner has shown with respect to the income allocable to the covenant not to compete is that she did not know the tax effect of such a covenant being part of a contract for the sale of stock.

Petitioner takes the position that she did not know, and had no reason to know, of the omission from income of any of the items determined by respondent to have been omitted. Petitioner further takes the position that she did not know, and had no reason to know, of the claimed deductions for bad debts and

worthless stock in connection with International Demolition and that the requirement of the item being grossly erroneous is met in that the claimed deductions are in an amount for which there is no basis in fact or law. Her position is that her failure to contest the determination of respondent that the claimed bad debt losses and worthless stock deduction are not allowable is sufficient to show that the deduction items are grossly erroneous.

Respondent argues that petitioner knew or certainly had reason to know of the claimed bad debt loss and worthless stock deductions, that these deductions are not grossly erroneous items as defined in section 6013(e)(2)(B) since they did have some basis in fact and law, and in any event petitioner has not established to the contrary. Respondent also argues that it would not be inequitable to hold

petitioner liable for the deficiency resulting from the disallowance of these claimed deductions under the facts and circumstances of this case.

In our view, petitioner did not know or have reason to know that personal expenses and personal travel were being paid for by Purcell Enterprises, Inc. and therefore did not know, or have reason to know, of the omission of these items from the joint tax returns she filed with her then husband. The record shows that petitioner had an American Express Card of Purcell Enterprises, Inc., which she used to pay travel expenses for herself and her husband when her husband was on a business trip. The record also shows that she used this card for certain personal items. However, the testimony shows that her husband represented to her that amounts charged on the American Express Card of Purcell Enterprises, Inc., had to be

justified as company expenses in order to be paid by the company and that any personal expenses which petitioner put on the card were being paid by him personally and not the company. In fact, the company comptroller testified that charges on the company's American Express Card were required to be justified in order for him to authorize payment by the company and in connection with charges involving the Purcells, he looked to Mr. Purcell for justification. Under the circumstances, we conclude that petitioner did not in fact know that the personal charges she put on the Purcell Enterprises, Inc., American Express Card were being paid for by the company rather than by her then husband and did not know that he was charging personal items to the company credit card.

In our view, petitioner must have known in connection with sale of the Reese

Tires, Inc., stock that the contract of sale contained a covenant not to compete. Although she did not assist in negotiating the sale, she was the owner of the stock and a signatory to the contract. One of the persons to whom the noncompete provision applied was petitioner and another was her then husband, Mr. Purcell. Not only did petitioner sign the contract, she initialed a change in the years for which the covenant not to complete was effective. Petitioner never specifically testified that she did not read the agreement with respect to the sale of stock that she signed, although she testified that her husband did all the negotiating. In our view, the evidence here does not support lack of knowledge on the part of petitioner with respect to the terms of the contract for the sale of the stock of Reese Tires, Inc. Certainly petitioner did not know the legal effect

of the provision with respect to a covenant not to compete. However, the cases are clear that the spouse claiming to be relieved from liability for omission from income of an item must be unaware of the circumstances which give rise to that omission and not merely to the tax consequences of the facts. McCoy v. Commissioner, 57 T.C. 732 (1972); Quinn v. Commissioner, 62 T.C. 223 (1974), affd. 524 F.2d 617 (7th Cir. 1975); Smith v. Commissioner, 70 T.C. 651, 672-673 (1978). As we pointed out in the Smith case, it is immaterial that both spouses were unaware of the tax liability created by the transactions of which they were aware. Here, we do not know whether Mr. Purcell was aware of the tax liability created by a part of the amount paid under the contract for sale of the Reese Tires, Inc., stock being allocable to a covenant not to compete, but it is clear that

petitioner did not know the tax consequences of having this provision in the contract. However, this is immaterial since we conclude that the evidence shows that she did know that the noncompete agreement was in the contract.

The record is clear that petitioner did know of loans made by her then husband to International Demolition. From the evidence we conclude that she did not examine the returns she filed with her then husband. We also conclude that she did not examine the returns sufficiently to know that there had been a deduction for worthless stock of International Demolition taken as a deduction on the returns. However, petitioner has made no showing as to the circumstances which caused these items to be deducted. The accountant testified that he thought when he prepared the joint returns of petitioner and her then husband that all

items in the returns were accurate. Certainly under these circumstances he must have done some investigation of the financial condition of International Demolition. The record shows that this company was in bad financial condition. In our view, petitioner's conceding that respondent's adjustments with respect to the worthless stock and bad debt deductions are correct is not sufficient to establish that the claimed deductions were in an amount for which there was no basis in fact or law. If the statute had intended that a mere concession that respondent was not in error in disallowing a claimed deduction was sufficient to cause the item to be grossly erroneous as having no basis in fact or law, it would have so provided.

Prior to the amendment of section 6013(e) by Pub. L. 98-369 in 1984, no relief was granted where the deficiency

was because of the disallowance of claimed deductions. Resnick v. Commissioner, 63 T.C. 524 (1975); Allen v. Commissioner, 61 T.C. 125, 132 (1973), affd. on this issue and revd. on another issue 514 F.2d 908, 915 (5th Cir. 1975). In explaining the reason for the change in the law with respect to disallowed deductions made by Pub. L. 98-369, in 1984, the House

Committee Report states that--

> The Committee believes that the present law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, for example, where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered. [Supplemental Report of Comm. on Ways and Means, H. Rept. 98-432 (Pt.2), on H.R. 4170 (Tax Reform Act of 1984), at 1502 (1984).]

This report further states with respect to

the changes in the bill as follows:

Under the bill, the innocent spouse (sec. 6013(e)) rule will apply to cases in which the tax liability results from a substantial understatement of tax that is attributable to grossly erroneous items (including claims for deductions or credits, as well as omitted income) of the other spouse. Grossly erroneous items include any item of income that is omitted from gross income, regardless of the basis for omission. A claim for deduction or credit will be treated as a grossly erroneous item only if the claim had no basis in law or fact. The bill defines a substantial understatement as any understatement of tax that exceeds $500. As under present law, relief may be granted only where it would be inequitable to hold the innocent spouse liable.

It is clear from the statute itself, and made even clearer by the committee reports, that whereas any omission of income resulting in an understatement of tax in excess of $500 is to be considered a grossly erroneous item, only deductions without a basis in fact or law are to be considered grossly erroneous. Therefore, in order to be relieved from tax resulting from a disallowed deduction, it

is incumbent on a taxpayer to prove that the claimed deduction not only is not properly allowable but that it has no basis in fact or law. To establish that the deduction is a grossly erroneous item under this definition is part of the burden of a taxpayer claiming to be an innocent spouse.

Here, petitioner has made no showing that the bad debt deductions which were disallowed by respondent and the worthless stock deduction that was disallowed had no basis in fact or law. All that has been shown is that she did not contest the adjustments as made by respondent. In fact, the evidence that is in the record with respect to these items indicates that they were not "grossly erroneous" from the standpoint of being "phony" deductions. The record shows that loans had been made by petitioner's husband to International Demolition and that that company was in

bad financial condition in 1977 and 1978. The accountant who prepared the joint returns of petitioner and her then husband testified that he thought he had sufficient information to justify the items shown on the returns, and the comptroller of Purcell Enterprises, Inc., who also handled the books of International Demolition, testified that he had furnished information to the accountant.

Under the facts of this case, there has been no showing that the claimed deductions had no basis in fact or law. They were not "phony" deductions as referred to in the committee report. We therefore conclude that petitioner is not an innocent spouse with respect to the claimed bad debts and worthless stock deductions.

Since respondent has conceded that

petitioner is an "innocent spouse" with respect to the constructive dividends received by her husband from the private use of the airplane owned by Purcell Enterprises, Inc., and we have concluded that petitioner did not know, or have reason to know, of the constructive dividends from the payments by that corporation of personal bills and travel, it is necessary for us to determine whether it would be inequitable to hold petitioner liable for the deficiency in tax attributable to these understatements of income.

Whereas the law prior to the 1984 amendment specifically referred to whether the spouse claiming relief from tax significantly benefitted from the omissions from income, the present law does not specifically contain this provision. However, even though the present statute does not specifically

refer to the other spouse receiving substantial benefits from the omissions or wrongfully claimed deductions, in our view it would not be inequitable to hold the other spouse liable for the deficiency if such substantial benefits were received. Therefore, we deem it necessary to determine whether petitioner received substantial benefits from the omission of the constructive dividends from the income reported on the returns.

The record shows no benefit to petitioner from her husband's use of the company plane and only very minor benefits received by petitioner from the payment by Purcell Enterprises, Inc., for a few meals and some lodging she charged to the American Express Card issued in her name. Certainly these benefits were not substantial. The record also shows that under the agreement incident to her divorce from Mr. Purcell, petitioner

received most of the property accumulated during the marriage of the parties and in addition Mr. Purcell was required to keep insurance policies payable to her in force to ensure periodic payments. Petitioner testified at the trial that the property which she received in the divorce settlement had been acquired by her and Mr. Purcell long before the years here in issue and that prior to the years here in issue she was actually the owner of the insurance policies which Mr. Purcell was required to keep in effect and had paid the premiums on these policies. She testified that she did not receive the periodic payments required under the agreement. Although not precisely shown in the record, petitioner apparently did receive the proceeds of the insurance policies upon Mr. Purcell's death. She testified about the requirement she was facing of paying Mr. Purcell's debts which

she had guaranteed. Petitioner claims that she did not substantially benefit from the various items of omitted income.

Since we have held that petitioner is not entitled to relief under section 6013(e) for the omitted income from the covenant not to compete or from the disallowance of the deductions for bad debts and worthless stock, we need only consider whether it would be inequitable to hold petitioner liable for the tax on the omitted income from constructive dividends. The regulation in effect with respect to the prior law provided, in section 1.6013-5(b), Income Tax Regs., that whether it is inequitable to hold a person liable for the deficiency in tax is to be determined on the basis of all the facts and circumstances.[4] This section of

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[4] Sec. 1.6013-5(b), Income Tax Regs., provides as follows:

(footnote continued)

the regulations states that in making the determination a factor to be considered is whether the person seeking relief significantly benefitted, directly or

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(footnote continued)

(b) Inequitable defined. Whether it is inequitable to hold a person liable for the deficiency in tax, within the meaning of paragraph (a)(4) of this section, is to be determined on the basis of all the facts and circumstances. In making such a determination a factor to be considered is whether the person seeking relief significantly benefitted, directly or indirectly, from the items omitted from gross income. However, normal support is not a significant "benefit" for purposes of this determination. Evidence of direct or indirect benefit may consist of transfers of property, including transfers which may be received several years after the year in which the omitted item of income should have been included in gross income. Thus, for example, if a person seeking relief receives from his spouse an inheritance of property or life insurance proceeds which are traceable to items omitted from gross income by his spouse, that person will be considered to have benefitted from those items. Other factors which may also be taken into account, if the situation warrants, include the fact that the person seeking relief has been deserted by his spouse or the fact that he has been divorced or separated from such spouse.

indirectly, "from the items omitted from gross income." This regulation goes on to say that normal support is not to be considered a significant benefit. It further refers to a person seeking relief receiving from his spouse "an inheritance of property or life insurance proceeds which are traceable to items omitted from gross income by his spouse."

Here, the record shows that the property received by petitioner in the divorce proceeding had been acquired in years prior to the years here in issue. Petitioner had paid the insurance premiums prior to her divorce from Mr. Purcell. The omitted income was from personal items paid by Purcell Enterprises, Inc. Clearly, the use of the airplane by Mr. Purcell for personal purposes in no way benefitted petitioner and the Government apparently does not contend to the contrary. Although

petitioner may have received some small benefit from the payment of travel and entertainment expenses by the corporation, from her testimony it is reasonably clear that whatever benefit she received was not significant. She only occasionally went on trips with Mr. Purcell and made insignificant charges on her American Express Card which she thought Mr. Purcell was personally paying.

Based on the record as a whole, we conclude that petitioner did not significantly benefit from the constructive dividends received by Mr. Purcell from Purcell Enterprises, Inc., because of the payment by that corporation of personal expenses for meals, travel and entertainment for Mr. Purcell and, to some extent, for petitioner. We therefore conclude that with respect to the entire constructive dividends from Purcell Enterprises, Inc., in each of the years

here in issue, petitioner is entitled to relief under section 6013(e).

Decision will be entered under Rule 155.

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 86-1678

FILED
Aug 18, 1987
John P. Hehman,
Clerk

JOYCE PURCELL,

Petitioner-Appellant,

v.

COMMISSIONER OF
INTERNAL REVENUE,

Respondent-Appellee.

Before: KENNEDY, JONES and RYAN,
Circuit Judges.

J U D G M E N T

ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said tax court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said tax court in

this cause be and the same is hereby affirmed.

IT IS FURTHER ORDERED that Respondent-Appellee recover from Petitioner-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said court, if necessary.

ENTERED BY ORDER OF THE COURT
John P. Hehman, Clerk

_____
Clerk

Issued as Mandate: October 14, 1987

Costs: APPELLEE TO RECOVER -

Filing fee....$
Printing.....$22.40

Total.....$22.40

A True Copy
Attest:

_____
Deputy Clerk

No. 86-1678

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

FILED
Oct 5, 1987
John P. Hehman
Clerk

JOYCE PURCELL,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ORDER

BEFORE: KENNEDY, JONES and RYAN, Circuit Judges

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of the Court, and no judge of this Court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the

petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

_____

John P. Hehman, Clerk

UNITED STATES TAX COURT

JOYCE PURCELL, Petitioner,	)	
v.	)	Docket No. 27793-83
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed on February 26, 1986, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income tax due from the petitioner for the taxable years 1977 and 1978 in the amounts of $66.,871.00 and $35,340.75, respectively.

(Signed) Irene F. Scott

Judge.

Entered: Apr 24, 1986

It is stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

_____ Dated: Apr 7, 1986
ALAN L. CATES, Esquire
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JEAN OWENS
Acting Chief Counsel
Internal Revenue Service

By:_____ Dated: Apr 16, 1986
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